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No. 73-1118

In the Supreme Court of the United States

OCTOBER TERM, 1973

FEHRS FINANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A-1—A-34) are reported at 58 T.C. 174. The opinion of the court of appeals (Pet. App. A-35—A-48) is reported at 487 F. 2d 184.

JURISDICTION

The judgment of the court of appeals (Pet. App. A-49) was entered on November 6, 1973. The petition for a writ of certiorari was filed on January 16, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether both courts below correctly held that petitioner's basis in the shares of an affiliated corporation was equal to the zero basis of the transferors in such shares under Section 362(a)(2) of the Internal Revenue Code of 1954, because petitioner acquired the shares in a Section 304 redemption transaction in which the transferors were not required to recognize any gain under Section 302.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 302, 304, 318 and 362 of the Internal Revenue Code of 1954 and Treasury Regulations Section 1.302–4 are set forth at Pet. App. A–50—A–57.

STATEMENT

Until 1964, the 1,380 shares of the stock of Fehrs Rental Company ("Rental") were owned entirely by Edward J. Fehrs (1,223 shares) and his wife (157 shares). During 1964 and 1965, Mr. Fehrs gave his wife, his two daughters, a son-in-law and his three grandchildren a total of 241 shares. After the gifts, Mr. Fehrs and his wife owned 982 and 177 shares, respectively (Pet. App. A–3).

In early 1965, the Fehrs' daughters organized a new corporation, Fehrs Finance Company, the petitioner. They subscribed to the initial issue of 19 shares at $100 per share. Immediately after its formation, petitioner entered into an agreement with Edward J. Fehrs and his wife to acquire their remaining Rental shares in return for two unsecured and nonassignable private annuities in the respective

amounts of $62,000 and $8,000 per year. On the same day that Mr. and Mrs. Fehrs transferred their 1,159 Rental shares to petitioner, petitioner transferred the shares to Rental for $100,000 in cash plus a note for $625,000. The Commissioner determined that petitioner's basis in those shares was zero and that it realized immediately $100,000 of taxable capital gain on this latter transaction (Pet. App. A-3—A-4, A-5—A-6, A-10—A-11).

Under Section 362(a)(2), petitioner's basis in such shares is equal to the redeemed shareholders' basis plus any "gain recognized" by the shareholders upon the transfer to petitioner. The Tax Court upheld the Commissioner's determination on the ground that petitioner's acquisition of the Rental shares was by means of a redemption through the use of a related corporation under Section 304(a)(1) of the Code. Pursuant to that provision, any gain to the transferor must be ascertained under the standards of Section 302. The Tax Court held that the former Rental shareholders did not recognize any gain under Section 302(b) so that their zero basis in the shares carried over to petitioner. Accordingly, the $100,000 in cash received by petitioner upon the sale of those shares was fully taxable as long-term capital gain (Pet. App. A-11—A-34). The court of appeals affirmed (Pet. App. A-35—A-46).

ARGUMENT

1. Section 362(a)(2) of the Code provides that a corporation's basis in property contributed to its capital is equal to the transferor's basis in such property

plus "the amount of gain recognized to the transferor on such transfer." It is undisputed that the Fehrs' basis in the Rental shares transferred to petitioner was zero. Thus, unless they recognized gain upon the transfer of their Rental shares to petitioner, petitioner's basis in the Rental shares would likewise be zero. If such is the case, the $100,000 cash down payment it received upon sale of the shares was fully taxable as capital gain.

Both courts correctly held that Mr. and Mrs. Fehrs did not recognize gain upon the transfer of their Rental shares to petitioner. It is undisputed that the tax consequences of that transfer is governed by Section 304 of the Code (Pet. 2). Section 304(a) provides that where two corporations are under common control, the acquisition by one (petitioner) of the stock of the other (Rental), shall be treated as a redemption of stock of the acquiring corporation (petitioner). As a redemption, the tax consequences must be determined by reference to Section 302. Section 304(b)(1) provides that the determination of the effect of the transaction under Section 302(b) shall be made with respect to the stock of the issuing corporation (Rental).

The question thereby becomes whether the transfer by Mr. and Mrs. Fehrs of their Rental shares to petitioner in exchange for the annuities was a taxable exchange under Section 302(b). Since the transaction must be treated as a redemption by them of their stock in Rental, Section 302(b) requires a comparison of their shareholdings in Rental before and after the transfer.

Both courts below correctly held that the redemption did not satisfy the "not essentially equivalent to a dividend" requirement under Section 302(b)(1) and did not meet the standards of a complete termination of interest under Section 302(b)(3). These provisions respectively allow a stock redemption to be treated as a distribution in exchange for the stock if it is "not essentially equivalent to a dividend" or if it is "in complete redemption of all of the stock of the corporation owned by the shareholder." These are the only possible provisions under Section 302 which would have caused the transaction to be treated as an exchange of their Rental shares for the annuities. As a result, the value of the annuities was a distribution of property under Section 302(d) and taxable as a dividend under Section 301 to the extent of the earnings and profits of petitioner. See Section 304(b)(2)(A).

The courts further concluded, however, that the annuity contracts received by Mr. and Mrs. Fehrs did not constitute taxable distributions of property under Section 301 of the Code because the value of these unsecured annuity contracts was speculative in nature (Pet. App. A-26—A-28, A-43—A-46). Since no gain was recognizable by Mr. and Mrs. Fehrs in the year of the redemption, petitioner's basis in the stock it had redeemed from them was their carryover basis of zero (Pet. App. A-31—A-32, A-46).

2. Petitioner challenges (Pet. 9–14) the holding of the courts below that the redemption by Mr. and Mrs. Fehrs of their Rental shares did not qualify as "not essentially equivalent to a dividend" under Section 302(b)(1).

With respect to the applicability of Section 302(b)(1), this Court held in *United States* v. *Davis*, 397 U.S. 301, 313, that to qualify under that provision, "a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."[1] Here, prior to the redemption, Mr. and Mrs. Fehrs owned directly and by operation of the attribution rules of Section 318 through which their daughters' Rental stock was attributed to them, 98.2 percent of the stock of Rental. Immediately after the redemption, they constructively owned the same 98.2 percent. Indeed, even after petitioner sold Rental the shares it had acquired and those shares had been cancelled, the interest of Mr. and Mrs. Fehrs in Rental, direct and attributive, was still substantial—88.7 percent.[2]

Petitioner nevertheless argues (Pet. 11–14) that the interest of Mr. and Mrs. Fehrs in Rental was meaningfully reduced within the meaning of *Davis*. Specifically, it urges that the courts below failed to credit fully the fact that even though their total control, actual and attributive, was not substantially affected by the re-

[1] Unlike this case, which involved a redemption of common stock, the two post-*Davis* cases cited by petitioner, in which certiorari was denied this Term, involved the identical situation presented in *Davis*, *viz.*, the pro rata redemption of preferred stock.

[2] The subsequent transfer of the acquired shares, or their ultimate cancellation, is irrelevant insofar as the operation of Sections 302 and 304 is concerned. The ultimate disposition of such shares by the acquiring corporation—even to a wholly unrelated party—is beside the point. Looking to their stock ownership after the redemption, rather than after petitioner's sale to Rental, Mr. and Mrs. Fehrs owned precisely the same 98.2 percent of Rental after the acquisition as they did before.

demption, their direct control over Rental was ended by the redemption.

The short answer to this contention is that neither Section 304 nor Section 302 provides any basis for making actual control determinative. These sections provide just the opposite, for Sections 302(c)(1), 304(b)(1) and 304(c)(2) all make the attribution rules of Section 318 controlling for purposes of determining stock ownership. Indeed, as this Court noted in *Davis*, Congress intended that those constructive ownership rules "be taken into account wherever ownership of stock was relevant" (397 U.S. at 307). See also *Coyle* v. *United States*, 415 F. 2d 488 (C.A. 4).

Contrary to petitioner's assertion, there is no conflict of decisions on this point. *Sorem* v. *Commissioner*, 334 F. 2d 275 (C.A. 10), cited by petitioner (Pet. 11–12), recognized that the attribution rules of Section 318 were controlling in determining whether redemption qualified under Section 302(b)(1). There, two shareholders each owned 50 percent of the corporation's stock prior to the redemption. After the redemption, the combined actual and constructive ownership of each was less than 50 percent, and each shareholder had thus surrendered whatever control he might have had prior to the redemption. The court held that that decline in the shareholder's proportionate interest was "significant" and noted that the redemption itself was motivated by "prudent business reasons" (334 F. 2d at 280). It thereby concluded that the redemption distribution was not essentially equivalent to a dividend.

Because this Court in *Davis* expressly held that business motivations for a redemption did not render the redemption distribution itself "not essentially equivalent to a dividend," the ongoing validity of *Sorem* has been significantly diminished. Nevertheless, *Sorem* offers no support with respect to the point raised by petitioner, for the Tenth Circuit did not distinguish between voting control exercised directly by the redeeming shareholder and control deemed to be exercised through the attribution of ownership of stock of a family member pursuant to Section 318. Indeed, *Sorem* specifically stated that it was both the direct and attributed ownership which was the basis of its holding under Section 302(b)(1).

Here, however, there was only a minimal decline in total proportional ownership which never even approached a loss of control. The fact that the courts below did not give direct ownership alone controlling weight does not conflict with *Sorem*.

Petitioner's reliance (Pet. 13–14) upon the Eighth Circuit's earlier decision in *Wright* v. *United States*, 482 F. 2d 600, is misplaced. Any conflict between the decision below and *Wright* would be an intra-circuit conflict not requiring resolution by this Court. A resolution of the alleged conflict might have been achieved by petitioner had it sought *en banc* reconsideration of this case by the Eighth Circuit.

In any event, petitioner's assertion of a conflict with *Wright* is erroneous. That case involved the tax treatment of a note received by a shareholder in a Section 368(a)(1)(A) merger reorganization. The tax character of such a distribution is determined by Section 356

(a)(2), which provides for ordinary income treatment if the distribution of "other property or money" "has the effect of the distribution of a dividend." In applying that standard, the court in *Wright* used the tests employed by it and other courts in determining whether a distribution was "essentially equivalent to a dividend" under Section 302(b)(1) and held that the distribution should not be equated to a dividend. As support for its conclusion, the court looked to the decline in the taxpayer's direct voting power and not at the effect the reorganization had on the total of his direct and attributive voting power.[3] Unlike this case involving a redemption with respect to which the Code specifically requires the application of the constructive ownership rules (see Sections 302(c), 304(b) and 304(c)(2)), those rules do not apply to a determination under Section 356(a)(2). See Section 318(a): *Berghash* v. *Commissioner*, 43 T.C. 743, 757, affirmed, 361 F. 2d 257 (C.A. 2). Thus, in *Wright*, only direct shareholding interests were relevant.

3. Petitioner further challenges (Pet. 14–20) the holding of both courts below that the redemption by Mr. and Mrs. Fehrs was not a complete termination of interest under Section 302(b)(3).

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[3] The court in *Wright* relied upon an earlier Tax Court case, *Estate of Squier* v. *Commissioner*, 35 T.C. 950, for its conclusion that the shareholder realignment was meaningful. In *Squier*, the Tax Court had found that a shareholder's surrender of direct control was enough to make a redemption not like a dividend even though the shareholder retained constructive control. The Tax Court has only recently held that its *Squier* decision was not consistent with this Court's subsequent decision in *Davis*, *Robin Haft Trust* v. *Commissioner*, 61 T.C., No. 45.

More than six years after they filed their return for 1965, and after the Tax Court had held their sale of Rental stock to petitioner to be a Section 304 redemption, Mr. and Mrs. Fehrs filed an agreement with the Internal Revenue Service which apparently sought to satisfy the requirements of Section 302 (c)(2) of the Code.[4] Under that provision, the family attribution rules of Section 318(a)(1) will not apply to a determination of whether a complete termination of interest has been achieved if three conditions are met. One of the conditions is the filing of an agreement with the Internal Revenue Service providing that the shareholder will notify the Service of any acquisition of stock of the corporation within ten years of the redemption. If the agreement in this case was timely filed, it is possible that the family attribution rules of Section 318 would not have applied with the result that redemption might have qualified as a complete termination under Section 302(b)(3).[5]

[4] Petitioner's statement (Pet. 15) that the agreement was "immediately filed" after Mr. and Mrs. Fehrs found that Sections 302 and 304 of the Code applied is not entirely accurate. The formal decision fixing the amount of the deficiency was entered by the Tax Court on September 25, 1972 (R. 2), and the agreement was dated September 30, 1972 (R. 12–13). However, the opinion of the Tax Court, holding the "sale" of stock to be a redemption under Sections 302 and 304 was filed on May 1, 1972 (R. 2). Thus, fully five months elapsed between the Tax Court opinion and the agreement. ("R." references are to the record appendix filed in the court of appeals.)

[5] Section 302(c)(2) agreements are ineffective to avoid the attribution rules if any of the members of the redeeming shareholder's attributive family had acquired stock in the corporation from him during the preceding ten-year period which was not redeemed along with the redeeming share-

In Section 302(c)(2)(A)(iii), however, Congress gave the Treasury authority to prescribe the time and manner in which such agreements should be filed. Section 1.302–4(a) of the Treasury Regulations on Income Tax provides, in pertinent part, that the Section 302(c)(2) agreement shall be "attached to * * * [a] return timely filed for the year in which the distribution described in section 302(b)(3) occurs." Since the agreement was not filed until after the Tax Court decision, petitioner first relied upon it before the court of appeals. That court held that the agreement was so belatedly filed that it was not entitled to any effect.

Petitioner argues (Pet. 15–16) that this holding conflicts with *United States* v. *Van Keppel*, 321 F. 2d 717 (C.A. 10). The taxpayer in that case, however, filed his Section 302(c)(2) agreement, together with an amended return, a little more than one year of the filing of his initial return and while the case was still in the administrative stage, well before litigation was initiated. Here, on the other hand, more than six years elapsed between the due date of the initial return to which the agreement should have been attached and the filing of the agreement after the Tax Court had decided against petitioner.

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holder's, unless that acquisition did not have as one of its principal purposes the avoidance of federal income tax. See Section 302(c)(2)(B). Here Mr. Fehrs had given his daughters and grandchildren, members of his attributive family (Section 318(a)(1)), shares of Rental stock within a year of the redemption, and those shares were not redeemed. Moreover, the gifts were apparently an integral part of their scheme for passing control of Rental to their children with little or no federal income tax. Thus, even a timely-filed Section 302(c)(2) agreement might well have been unavailing in this case.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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